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BEFORE THE

SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 35506

WESTERN COAL TRAFFIC LEAGUE – PETITION FOR DECLARATORY ORDER

REPLY COMMENTS OF
ALLIANCE FOR RAIL COMPETITION
MONTANA WHEAT & BARLEY COMMITTEE
COLORADO WHEAT ADMINISTRATIVE COMMITTEE
IDAHO BARLEY COMMISSION
IDAHO WHEAT COMMISSION
MONTANA FARMERS UNION
NEBRASKA WHEAT BOARD
OKLAHOMA WHEAT COMMISSION
SOUTH DAKOTA WHEAT COMMISSION
TEXAS WHEAT PRODUCER BOARD
WASHINGTON GRAIN COMMISSION
NATIONAL ASSOCIATION OF WHEAT GROWERS

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Dated: November 28, 2011

In the Opening Comments filed October 28, 2011 in this proceeding, the Alliance for Rail competition ("ARC") and the other agricultural producer and shipper groups joining with ARC (hereafter, ARC, et al.) explained that allowing BNSF to take a write-up of some $8 billion based on the acquisition premium paid by Berkshire Hathaway is objectionable for many reasons, but is particularly problematic for the many shippers and producers of agricultural commodities that are captive to BNSF. Notably, the U.S. Department of Agriculture and other shipper interests, including the National Corn Growers Association, also raised concerns about adverse impacts on farmers and shippers in the agricultural community.

ARC, et al. also generally supported the Opening Comments, and now support the Reply Comments, filed by Western Coal Traffic League, NITL, and other shipper interests. ARC's membership includes major shippers of coal, glass and other agricultural and non-agricultural commodities, and the issues presented here affect all captive shippers of all commodities via BNSF, as well as captive shippers via other railroads that might become acquisition targets if the Board were to accept BNSF's arguments.

In many western states, agriculture is either the most important segment of the local economy or is one of the most important. Moreover, adverse impacts on agriculture have significant ripple effects on other businesses, as well as on state and local governments and budgets, vendors, customers and consumers, jobs, and exports.

These realities were ignored in BNSF's Opening Comments, in which BNSF went so far as to suggest that only Western Fuels Association, Inc. and Basin Electric Power Cooperative, Inc. will be the only rail customers directly affected. This is nonsense, but ARC, et al. will have to see BNSF's Reply Comments before responding, on rebuttal, to BNSF's arguments as to the role of the acquisition premium in setting or challenging rate levels for captive agricultural and other shippers and producers.

In this round of this proceeding, the comments of ARC, et al. are accompanied by the attached Reply Verified Statement of G.W. Fauth III, addressing arguments and witness statements in BNSF's Opening Comments. As Mr. Fauth points out, BNSF's reliance on Generally Accepted Accounting Principles is flawed, as recognized by no less an authority than Warren Buffett, CEO of Berkshire Hathaway. See Fauth Reply V.S. at 2, where Mr. Buffett is quoted as warning against "managers who actively use GAAP to deceive and defraud." BNSF has not even claimed, let alone demonstrated, that Berkshire Hathaway anticipated favorable regulatory treatment and reduced R/VC percentages when it acquired BNSF.

BNSF also argues that the circularity problem described as fatal by Professor Alfred Kahn does not apply here because many BNSF shipments are not captive and are therefore unaffected by rate reasonableness standards established by Congress.

BNSF has it backwards. The fact that relatively little BNSF traffic is jurisdictional makes it more important, not less important, that BNSF costing be adjusted to eliminate the acquisition premium.

The fact that many BNSF shippers have competitive alternatives means that BNSF has less need of an $8 billion windfall than might a company that was pervasively regulated. Moreover, as a matter of law, the only rail rate levels that "must be reasonable" under 49 U.S.C. § 10701(d) are rates on captive traffic. In other regulated industries revenues from all customers and rates for classes of customers may be capped, and are likely to be capped where there is monopoly power.

BNSF can charge what it likes on competitive shipments, and has demonstrated during the worst economic slump since the Great Depression that it can raise rates and gain market share even where it lacks monopoly power. It was the existence of significant volumes of unregulated freight that led the RAPB to find circularity concerns "probably unfounded at this time," almost 25 years ago. RAPB Final Report at 46-47. However, even then, the RAPB adopted, as its Statement of Principle that "where GAAP cost reasonably cannot be viewed as a meaningful regulatory measure of value, other measures of value may be used." Final Report at 39. Similarly, as to revenue adequacy, the RAPB Final Report said (at page 62) "the ICC may determine that GAAP cost is not a meaningful value in certain circumstances and may elect to use another measure, such as predecessor cost."[1]

It does not follow from the RAPB's qualified support for GAAP as to most freight that the Board should not treat captive traffic as an exception to general rule.

In addition, much of BNSF's freight may be non-jurisdictional, and therefore irrelevant for purposes of this proceeding, and some captive traffic may be subject to rate prescriptions or pending proceedings, and therefore subject to the Board's direct scrutiny, which plainly may include appropriate case-specific determinations. However, there are many captive shippers via BNSF whose rates are neither non-jurisdictional nor under present or recent scrutiny.

BNSF plainly considers regulatory factors, including URCS costs, in developing pricing as well as terms and conditions for captive shipments, despite the claim that it charges market-

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[1] As Witness Fauth explains, Reply V.S. at 9, exclusion of BNSF from the Board's 2010 revenue adequacy calculation adversely affected captive shippers via CSXT and NS, as well as BNSF.

based rates.[2] And if the Board does not adjust BNSF costing to prevent a write-up, regulatory inaction will permit higher rates for some of BNSF's most vulnerable customers.

FERC or a state public service commission can set costs of service and allocate revenue responsibility for all jurisdictional rate payers. Moreover, the interests of residential and small commercial customers are typically safeguarded by Commission Staffs or People's Counsel, and are, in any event, a significant and continuing focus of agency decision-makers when a utility seeks a rate increase. In contrast, the STB generally acts only when a complaint is filed, and then looks only at issues raised by the complainant shipper. Proceedings like this one are therefore of critical importance.

Even among utility coal shippers, rate cases have been rare, despite BNSF coal rates that usually exceed 180% of variable cost. The difficulty of challenging excessive rates is even greater for shippers of wheat, corn and other agricultural commodities. Montana is widely recognized to be the most captive State in the U.S., due to BNSF control over more than 95% of rail shipments. Various studies have found BNSF rates there produce R/VCs well above 180%, but no rate case has been filed as to BNSF grain rates since McCarty Farms, which took over 17 years but produced no relief for shippers that the ICC found to be captive to BNSF. Areas of captivity also exist in North Dakota, South Dakota, Nebraska, Colorado, Oklahoma, Texas, Idaho and Washington.

BNSF market dominance means high rates, and a write-up of $8 billion in BNSF's URCS costs will mean higher rates, affecting entire states, regions and industries. There are some states in which other railroads may provide service, but effective competition keeping BNSF rail rates

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[2] See, e.g., the oral argument transcript in STB Docket NOR 42124, State of Montana v. BNSF Railway Co., where BNSF counsel Richard Weicher stated that one goal of the shipment size limit challenged in that case was "to protect from under regulatory challenges." Transcript at 11.

below jurisdictional levels is rare or nonexistent. Even if the effect of the acquisition premium does not render rates non-jurisdictional, BNSF will benefit because fewer rate cases will be viable, less relief will be available in cases that are viable, and negotiations between BNSF and captive shippers will become yet more one-sided in BNSF's favor. As Witness Fauth says, rate increases exceeding 10% could result from system-wide variable cost increases that, according to BNSF, would amount to 5.6% in 2010. Moreover, rate increases are unlikely to be uniform. Reply V.S. at 8.

Moreover, rate cases are expensive, time-consuming, subject to relief caps, or otherwise compromised. The Three Benchmark test, which is the approach most likely to be pursued by a small or medium-sized grain elevator, is subject to a low relief cap, limited by the need in some cases to use comparable rates well above 180% of variable cost, and can in any event be neutralized or undermined by the simple expedient of charging all comparison group shippers similarly high rate levels. See Fauth Reply V.S. at 9-10 regarding adverse impacts of the acquisition premium on BNSF's RSAM percentage.

Under the circumstances, BNSF does not need, and the public interest does not permit affording it, the ability to reduce its R/VC percentages on captive traffic substantially, merely because it was acquired by Berkshire Hathaway. And Berkshire Hathaway, for its part, has expressed great satisfaction with the benefits of its acquisition even without the enhanced immunity from regulatory recourse that would accompany an URCS cost write-up of $8 billion.

For the forgoing reasons, the Board should exclude the acquisition premium from BNSF's URCS costs, and exclude the premium for revenue adequacy purposes.

Respectfully submitted,

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Dated: November 28, 2011

CERTIFICATE OF SERVICE

I hereby certify that I have this 28th day of November, 2011, caused copies of the foregoing document to be served on all parties of record by first-class mail.

John M. Cutler, Jr.

S:\mcd\ARC Reply Comments

BEFORE THE

SURFACE TRANSPORTATION BOARD

STB DOCKET NO. FD 35506
WESTERN COAL TRAFFIC LEAGUE -
PETITION FOR DECLARATORY ORDER

REPLY VERIFIED STATEMENT
OF
GERALD W. FAUTH III

My name is Gerald W. Fauth III. I am President of G. W. Fauth & Associates, Inc., an economic consulting firm with offices at 116 South Royal Street, Alexandria, Virginia 22314. I previously submitted a verified statement in this proceeding on October 28, 2011 on behalf of Alliance for Rail Competition, Montana Wheat & Barley Committee, Colorado Wheat Administrative Committee, Idaho Barley Commission, Idaho Wheat Commission, Montana Farmers Union, Nebraska Wheat Board, Oklahoma Wheat Commission, South Dakota Wheat Commission, Texas Wheat Producer Board, Washington Grain Commission and National Association of Wheat Growers. A statement describing my background, experience and qualifications is attached thereto as Appendix GWF-1.

I have been asked to submit these reply comments in response to the opening evidence and argument of BNSF Railway Company (BNSF) and other parties in regard to the potential economic impacts and other issues associated with the write-up in BNSF Railway Company's (BNSF) investment base as a result of the Berkshire Hathaway Inc. (Berkshire) 2010 acquisition of BNSF.

GAAP-Based Purchase Accounting

BNSF places great emphasis on the fact that the accounting adjustments made to its 2010 Annual R-1 Report are consistent with approved "GAAP-based purchase accounting" procedures.[1] Whether or not the accounting adjustments made by BNSF are consistent with GAAP standards is not the issue here. The STB is not required to blindly follow GAAP accounting standards in regulatory rate-making and certainly has the authority to make appropriate adjustments when necessary. Mr. Buffett himself warned that investors should be cautious of GAAP accounting:

> There are managers who actively use GAAP to deceive and defraud. They know that many investors and creditors accept GAAP results as gospel. So these charlatans interpret the rules "imaginatively" and record business transactions in ways that technically comply with GAAP but actually display an economic illusion to the world. As long as investors - including supposedly sophisticated institutions - place fancy valuations on reported "earnings" that march steadily upward, you can be sure that some managers and promoters will exploit GAAP to produce such numbers, no matter what the truth may be. Over the years, Charlie Munger and I have observed many accounting-based frauds of staggering size. Few of the perpetrators have been punished; many have not even been censured. ***It has been far safer to steal large sums with a pen than small sums with a gun.*** (emphasis added)[2]

ICC/STB Precedent in Past Railroad Transactions

BNSF also maintains that the issue regarding the exclusion of acquisition costs "has long been settled" by the STB and others and states since "the late 1980's, the ICC and then the STB consistently applied the acquisition cost principle to value railroads' assets after a merger or acquisition.[3] BNSF includes comparisons with the following past transactions:

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1 See, e.g., BNSF Opening Evidence and Argument in STB Finance Docket 35506, dated October 28, 2011, pages 1 though 4.

2 http://www.investorwords.com/tips/219/be-cautious-of-gaapbased-accounting.html

3 See BNSF Opening Evidence and Argument in STB Finance Docket 35506, dated October 28, 2011, page 2 and 8.

- The 1989 acquisition of Chicago and North Western Transportation Company by Blackstone Capital Partners L.P.(CNW/Blackstone);
- The 1995 Class I railroad merger between Burlington Northern Railroad Company and the Atchison, Topeka and Santa Fe Railway Company; (BN/ATSF)
- The 1996 Class I merger between Union Pacific Railroad and Southern Pacific Transportation Company (UP/SP);
- The 1998 Class I transaction which involved CSX Transportation Company and Norfolk Southern Railway Company acquisition and split of Consolidated Rail Corporation (CSX/NS/Conrail); and
- The 1999 Class I acquisition of Illinois Central Railroad Company by Canadian National Railway Company (CN/IC).

BNSF claims that the resulting increase in BNSF's net investment (which is estimated to be 39%) "is smaller the changes resulting from virtually all other recent railroad acquisition."[4] While it may be true that the ICC and STB have previously allowed purchase accounting adjusted in previous cases, BNSF comparisons are misleading and irrelevant. As indicated in my opening statement in this proceedings, this case is very different from past Class I railroad merger cases.

With a single exception (CNW/Blackstone), recent past Class I cases have involved railroad mergers and transactions involving two or more railroads and the acquisition premiums (which were considerably smaller) were spread throughout the newly-established railroad systems (e.g., BN/ATSF, UP/SP, CSX/NS/Conrail, and CN/IC).[5] In these prior Class I merger cases, new economic synergies were created as a result of the mergers or transactions which

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4 See Joint Verified Statement of Michael R. Baranowski and Benton V. Fisher, pages 4 and 5.

5 It should be noted that UP was one of the Blackstone investors and subsequently acquired 25% of CNW in 1989 and gained complete control of CNW in 1995. BNSF did not include an analysis of the UP/CNW merger in its analysis.

could, in theory, offset any increase in the investment base as a result of any associated acquisition premiums. There are no potentially offsetting synergies or acquisition benefits here. It is truly an apples to oranges comparison.

The CNW/Blackstone transaction could be viewed as comparable in that it was an acquisition of a Class I railroad by a non-railroad company and thus was not a railroad merger involving two or more railroads. However, the CNW/Blackstone transaction pales in comparison with the BNSF/Berkshire transaction and the acquisition premium was minimal in comparison. Although classified as a Class I railroad at the time, CNW was one of the smallest Class I carriers and was essentially a regional railroad with approximately 5,600 miles of road, whereas the BNSF/Berkshire transaction involved one of the largest (if not the largest) Class I carriers which dominates a large railroad market and operates over 32,000 miles of road.

By BNSF's own calculations, CNW's net investment increased by only $152 million as a result of the CNW/Blackstone transaction, whereas BNSF's net investment increased by $8.975 billion as a result of the BNSF/Berkshire transaction.[6] Clearly, the CNW/Blackstone transaction is not comparable in size and scope to the BNSF/Berkshire transaction or, for that matter, recent Class I mergers as seen in the following table:

[6] See Joint Verified Statement of Michael R. Baranowski and Benton V. Fisher, page 5, Table 3.

Table 1

Witnesses Baranowski's and Fisher's Analysis of
Effects on Net Investment From Recent Acquisitions
($ millions)

Transaction	Pre-Acquisition Net Investment	Post-Acquisition Net Investment	Difference	Percentage Change
BNSF/Berkshire	$23,081	$32,056	$8,975	39%
UP/SP	$4,551	$7,901	$3,350	74%
CN/IC	$1,161	$4,509	$3,348	288%
BN/ATSF	$3,812	$6,564	$2,752	72%
NS/Conrail	$3,188	$4,553	$1,365	43%
CSXT/Conrail	$2,308	$3,248	$940	41%
CNW/Blackstone	$959	$1,111	$152	16%

Regulatory Impact

BNSF argues that captive shippers are essentially lucky because "only $8 billion of the $22 billion premium that Berkshire paid over book value" was allocated to "BNSF's assets and liabilities" and the rest, $14 billion, was allocated to "goodwill."[7] BNSF also makes the extraordinary claim that "*none* of the acquisition premium paid by Berkshire over the pre-acquisition market price of BNSF is included in the value of BNSF's assets for regulatory purposes."[8] BNSF states that "every dollar paid by Berkshire Hathaway in excess of that $76 per market price was attributed to goodwill, and had no effect at all on BNSF's regulatory asset base, since goodwill is not included there"[9]

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7 See BNSF Opening Evidence and Argument in STB Finance Docket 35506, dated October 28, 2011, page 3.

8 *Ibid.*

9 BNSF Verified Statement of Thomas N. Hund, page 6.

Acquisition premiums in railroad mergers are defined by the STB as "the difference between the value of a company based upon either the book value or the price of a single share of stock before a tender offer and the price that the buyer actually has to pay to obtain control."[10] By either STB definition, i.e., book value or stock price, it is clear that BNSF's statement that the premium will have no effect on BNSF's regulatory asset base is erroneous and very misleading.

Based on the numbers presented by BNSF Witness Hund, BNSF had a book value of $13 billion prior to the transaction and the value of the Berkshire transaction was $35 billion,[11] which represents an acquisition premium of **$22 billion** ($35 minus $13 billion) under the STB's "book value" definition. Under the stock price approach, Witness Hund indicates that the stock price was $76 prior to the transaction. Berkshire agreed to pay $100 per share for BNSF's outstanding shares and assume approximately $10 billion in BNSF's debt. As of November 1, 2009, the BNSF's had 340,522,033 shares of outstanding Common Stock. Based on BNSF's market value of $35 billion, the acquisition premium would be **$9 billion** ($35 minus $26 billion). The difference between the acquisition premiums based on book value approach ($22 billion) and stock price approach ($9 billion) is $13 billion, which also represents the difference between the pre-transaction market value ($26 billion) and the pre-transaction book value ($13 billion). BNSF maintains that the "market had already determined" that BNSF's value "greatly exceeded its book value," i.e, the $13 billion difference, and that only $8 billion was actually allocated to BNSF assets.[12]

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[10] See STB Parte No. 582 (Sub-No. 1), Major Rail Consolidation Procedures (served June 11, 2001) at 28.

[11] In the BNSF and Berkshire press release dated November 3, 2009 announcing the transaction, the transaction value was listed as $44 billion comprised of a $34 billion investment in BNSF shares and the assumption of $10 billion of outstanding BNSF debt.

In other words, BNSF apparently views the adjustments as market corrections rather than acquisition premium adjustments. The facts are clear. BNSF's own numbers as reflected in its R-1 Report to the STB show that net assets increased by approximately $8 billion as a direct result of the Berkshire transaction. It is wrong and misleading to claim that the Berkshire transaction "had no effect at all on BNSF's regulatory asset base." If the Berkshire transaction had not occurred, BNSF's book value would have remained at $13 billion.

Impact on BNSF Customers

BNSF maintains that the acquisition premium will have little impact on BNSF customers. BNSF Witness Hund states that "BNSF's policy and practice is to set rates based upon market demand, not costs." Therefore, he maintains that the adjustments "will not directly translate into BNSF imposing any rate increases." Witness Hund maintains that there is "only one current customer" where the rate is set by a STB-prescribed Revenue-to-Variable Cost (R/VC) ratio and there may be a "modest effect" in this "unique situation."[13] Witnesses Baranowski and Fisher also maintain that the impact on BNSF customers would be negligible. They estimate that less than 2% of BNSF movements "would move from above to below the jurisdictional threshold."[14]

BNSF's claims of limited customer impacts are absurd. If the whole reason that STB develops and publishes URCS data for BNSF is for the sole benefit of a single, unnamed customer, then I submit that there is no reason for the STB to develop URCS or for the STB to exist. Moreover, if it would have such a limited impact, then why is BNSF vigorously fighting an URCS adjustment?

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[12] BNSF Verified Statement of Thomas N. Hund, page 6

[13] *Ibid.* pages 8 and 9.

[14] BNSF Joint Verified Statement Baranowski and Fisher, pages 5 and 6.

BNSF pays close attention to URCS costs when setting rates for captive traffic, which is indicated by the Waybill Sample and other data. Moreover, many rate contracts have escalation agreement tied to URCS. There is a very close correlation between BNSF's URCS cost levels and BNSF's captive rate levels. There is no doubt that as BNSF's URCS costs increase (which they will if the Berkshire acquisition premium is included), BNSF's captive rates will also increase.

Indeed, it certainly could be viewed as imprudent, irresponsible and a management inefficiency if BNSF failed to look at URCS costs as a benchmark when setting captive rates, especially since 2007 when the STB adopted new rate reasonableness standards, which rely heavily on URCS, and adopted the "unadjusted" URCS approach.[15] For example, say BNSF determines that the market rate for a captive movement is $1,000 per car, but under STB's unadjusted URCS BNSF could charge over $2,000 per car. Conversely, say BNSF determines that the market rate is $2,000 per car, yet under unadjusted URCS a rate of $1,000 generates a R/VC well above the STB's jurisdictional threshold of 180%. BNSF would have the Board believe that it only looks at the market and ignores URCS costs in ratemaking, even in situations in which BNSF could charge higher rates or charge rates which are too high and carry the risk of a STB rate complaint.

BNSF maintains that the acquisition premium adjustments would increase BNSF's system-wide 2010 URCS variable costs by only 5.6%. BNSF's estimate may be accurate, but the amount of the increase in variable cost will vary by movement. BNSF also ignores the fact that variable costs are marked-up in rate-making. Therefore, a 5.6% variable cost increase could easily translate into rate increases which exceed 10%.

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[15] See STB Ex parte No. 646 (Sub-No.1), Simplified Standards for Rail Rate Cases, served September 5, 2007, page 26.

Impact on Revenue Adequacy

The Berkshire/BNSF transaction and acquisition premium adjustments that BNSF has made to its R-1 Annual Report data have already had an impact on BNSF's revenue adequacy. In Ex Parte No. 558 (Sub-No. 14) – Railroad Cost of Capital – 2010, served October 3, 2011, the Board determined that the 2010 composite cost of capital was 11.03%. However, as a result of the Berkshire/BNSF transaction, the Board, for the first time, excluded BNSF (one of the largest railroads) from its composite cost of capital calculations. It is likely that the cost of capital would have been lower than 11.03% if BNSF had been included in the STB composite cost of capital calculations. In Ex Parte No. 552 (Sub-No. 15), Railroad Revenue Adequacy – 2010 Determination, served November 3, 2011, the Board determined that BNSF's 2010 return on investment (ROI) was 9.22%, which was below the composite cost of capital of 11.03%. BNSF estimates that its 2010 ROI would have been almost 11% without a purchase accounting adjustment.[16] Thus, if BNSF had been included in the STB's 2010 composite cost of capital calculation and an adjustment had been made to BNSF's 2010 ROI to exclude BNSF's purchase accounting adjustment, it is likely that BNSF would have been found to be revenue adequate.[17]

Impact on RSAM and R/VC>180 Benchmarks

BNSF estimates that the inclusion of purchase accounting adjustments would have a fairly significant impact on BNSF's 2010 RSAM calculation, which would be utilized in rate cases employing the STB's Three-Benchmark test. BNSF estimates that the 2010 RSAM percentage would increase significantly and the RSAM/R/VC>180 markup would increases from

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16 See Figure 1 in the Joint Verified Statement of Baranowski and Fisher, page 7.

17 It is also possible that, if BNSF had been included in the 2010 composite cost of capital (11.03%), which would have reduced the percentage, CSXT (10.85% ROI) and NS (10.96% ROI) may have also been found to be revenue adequate.

1.086 to 1.141 as a result of the inclusion of the purchase accounting adjustments[18] BNSF apparently did not included a restatement of the 2010 R/VC>180 benchmark. It is likely that the 2010 R/VC>180 benchmark would decline with the inclusion of the purchase accounting adjustments.

<u>Summary</u>

Although BNSF's purchase accounting adjustments are by far the largest in Class I railroad history and include no potentially off-setting synergies or economies associated with Class I railroad mergers, BNSF would have the Board believe that the purchase accounting adjustments made to its 2010 STB Annual R-1 Report are minimal and will have virtually no impact on BNSF's customers or STB's regulations. However, the facts are clear and BNSF's own evidence shows that the impacts are significant, broad and far-reaching. As a result, the Board should exclude these purchase accounting adjustments from BNSF's URCS and ROI calculations. The Board should also adopt a methodology which would allow for the inclusion of BNSF in the STB's composite cost of capital calculations.

[18] BNSF Joint Verified Statement Baranowski and Fisher, page 8, Table 4.

VERIFICATION

The foregoing statement is true and accurate to the best of my belief and knowledge.

Gerald W. Fauth, III

Subscribed and sworn to before me this 25th day of November 2011.

Notary Public

My commission expires: February 28th 2014

WILSON WATTS NASH COMMONWEALTH OF VIRGINIA NOTARY PUBLIC

Wilson Watts Nash
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My Commission Expires
February 28, 2014